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In the Supreme Court of the United States

OCTOBER TERM, 1988

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

MERIT LIFE INSURANCE COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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43 pp

QUESTION PRESENTED

Whether "ceding commissions" payable by a reinsurer to the initial insurer as consideration for the right to share in the future income stream from a block of life insurance policies reinsured under contracts of indemnity reinsurance are fully deductible in the year paid, or, instead, whether such payments must be capitalized and amortized over the estimated life of the reinsurance agreements.

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v.

MERIT LIFE INSURANCE COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra,* 1a-23a) is reported at 853 F.2d 1435. The memorandum opinion of the Tax Court (App., *infra,* 25a-30a) is reported at 52 T.C.M. (CCH) 658.

JURISDICTION

The judgment of the court of appeals (App., *infra,* 24a) was entered on August 11, 1988. On November 1, 1988, Justice Stevens extended the time for filing a petition for a writ of certiorari to and including December 9, 1988. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISION INVOLVED

Section 809(c)(1), 26 U.S.C. (1976 ed.), provides:

> **Gross amount**
>
> For purposes of subsections (b)(1) and (2) [pertaining to "gain and loss from operations"], the following items shall be taken into account:
>
> **Premiums**
>
> The gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts (including contracts supplementary thereto); less return premiums, and premiums and other consideration arising out of reinsurance ceded. Except in the case of amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded, amounts returned where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management shall not be included in return premiums.

STATEMENT

1. Respondent is an Indiana corporation engaged primarily in the business of writing and reinsuring life insurance policies. During the years in question, it qualified for federal income taxation as a life insurance company under Section 801 of the Internal Revenue Code.[1] During

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[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect in 1973-1975, the years at issue (the Code).

the years 1973 through 1975, respondent entered into five indemnity reinsurance agreements as reinsurer,[2] with respect to five separate blocks of life insurance policies written by American General Life Insurance Company.[3] Under these agreements, respondent agreed to reinsure specified percentages of the five blocks of policies issued by American General in return for receipt of the same percentage of future premiums (less expenses) received by American General thereon. App., *infra*, 3a-4a, 28a.

Three of the agreements were "conventional coinsurance agreements," under which American General agreed to transfer to respondent, as consideration for assuming reserve liabilities on the reinsured policies, amounts equal to the reserves respondent was thereafter required to carry on those policies. Respondent, in turn,

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[2] In indemnity reinsurance of the types involved here, the initial insurer and the reinsurer agree to share the premiums, expenses, and liabilities on a block of existing policies. The reinsurer in "indemnity reinsurance" does not become directly liable to policyholders, but agrees only to indemnify the initial insurer for its losses; the initial insurer continues to receive premiums and to pay expenses and benefits to the policyholders. This method of reinsurance contrasts with "assumption reinsurance," in which the reinsurer, in effect, steps into the shoes of the issuing company with respect to the policies, becoming directly liable to the policyholders and directly entitled to premium payments made by them. See generally App., *infra*, 1a-3a; *Modern American Life Ins. Co.* v. *Commissioner*, 830 F.2d 110, 110 n.2 (8th Cir. 1987).

[3] Four of the blocks of reinsured policies were originally issued by American General Life Insurance Company of Delaware, and the fifth block was initially issued by American General Life Insurance Company of New York (App., *infra*, 3a-4a).

agreed to pay American General "ceding commissions" in lesser amounts for the rights it acquired to the future profits from the reinsured policies. The ceding commissions were then netted against the greater amount of consideration flowing to respondent under those agreements.[4] Two of the agreements were "modified coinsurance agreements," under which American General continued to maintain the reserves on the reinsured policies. The ceding commissions on those agreements were paid outright by respondent to American General. App., *infra,* 4a & n.2, 27a-29a.[5] The ceding commissions for the five transactions aggregated $1,414,467, $898,213 and $2,014,899 for the years 1973, 1974, and 1975, respectively (*id.* at 28a-29a). Each of the agreements provided that American

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[4] On the first coinsurance agreement, entered September 1, 1973, a ceding commission of $1,414,467 was netted against consideration payable to cover respondent's increased reserves in the amount of $6,548,458. Thus, respondent received a net amount of $5,133,991. On the second coinsurance agreement, entered December 1, 1974, respondent agreed to pay a ceding commission of $423,213, to be netted against the sum of $1,526,523 payable to respondent to cover increased reserves. Thus, it received a net amount of $1,103,310 on that transaction. On the third coinsurance agreement, entered December 1, 1975, a ceding commission of $414,899 was netted against consideration payable to respondent to cover reserves of $1,443,557, so that respondent received the net amount of $1,028,658. Under each of these agreements, American General agreed to turn over a specified percentage of gross premiums thereafter received on the reinsured policies, and respondent agreed, in turn, to indemnify American General for a concomitant portion of claims paid and policyholder dividends, along with a specified allowance to cover its share of commissions, premium taxes, and other expenses incurred by American General. App., *infra,* 4a, 28a-29a.

[5] The first modified coinsurance agreement, dated April 1, 1974, provided for a ceding commission of $475,000. The second modified coinsurance agreement, dated October 1, 1975, provided for a ceding commission of $1,600,000. Respondent was then entitled to receive a

General could recapture the reinsured policies on specified future dates (*id.* at 4a).

2. On its corporate income tax returns for 1973-1975, respondent sought to deduct the full amount of the "ceding commissions" in the years of payment. Thus, respondent reported tax losses of $1,414,467 for 1973, $898,213 for 1974, and $2,014,899 for 1975 as a result of the reinsurance transactions, although those transactions presumably had been entered into by ~~petitioner~~ Respondent with the expectation that they would be profitable.[6] The Commissioner disallowed the deductions claimed for the ceding commissions. The Commissioner determined that these

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percentage of American General's investment income equal to the percentage of the block of policies reinsured by respondent, as well as a share of gross premiums thereafter received. Respondent, in turn, agreed to pay American General an allowance for expenses and a share of claims paid (with appropriate credit based on the retained reserves). In effect, then, it was assuming liability for a share of excess losses (*i.e.*, claims in excess of reserves), and was sharing, pro rata, in American General's net income from the reinsured policies. App., *infra*, 3a-4a & n.1, 27a-29a & n.3.

Respondent and American General elected, pursuant to Section 820 of the Code, to treat these modified coinsurance transactions for tax purposes as if they were conventional coinsurance agreements, *i.e.*, as if respondent had been required to assume the reserves with respect to its share of the reinsured policies and as if American General had transferred equal amounts of its assets to respondent to cover those reserves. App., *infra*, 3a n.1, 27a n.3.

[6] The other aspects of the reinsurance transactions generated no taxable gain or loss to petitioner. The reinsurance premiums received (or deemed received under Section 820) by petitioner from American General were reported as income, but those amounts were exactly offset by deductions allowed for the concomitant increase in petitioner's reserve liabilities for the reinsured policies. App., *infra*, 5a.

amounts represented the acquisition costs for economic benefits having a useful life beyond the year of payment—namely, the right to respondent's share of the future income stream paid on the reinsured policies. Accordingly, the Commissioner reasoned that the ceding commissions should be capitalized and amortized over the estimated life of each agreement (which ranged between 57 and 64 months). App., *infra,* 4a-6a.

Respondent Petitioner filed a petition in the Tax Court seeking redetermination of the resulting deficiencies, and the Tax Court ruled in its favor (App., *infra,* 25a-30a). Declining to reconsider its prior decision in *Beneficial Life Ins. Co.* v. *Commissioner,* 79 T.C. 627 (1982), the court held that ceding commissions paid to the initial insurer in an indemnity reinsurance transaction may be deducted in full in the year of payment as "return premiums [or] * * * other consideration arising out of reinsurance ceded" under Section 809(c)(1) of the Code, notwithstanding the fact that ceding commissions in the case of assumption reinsurance transactions would have to be amortized over the estimated life of the agreements (App., *infra,* 29a-30a; see 79 T.C. at 644-648).

3. The court of appeals affirmed (App., *infra,* 1a-23a). Noting its disagreement with the Eighth Circuit's decisions in *Modern American Life Ins. Co.* v. *Commissioner,* 830 F.2d 110 (1987), and *Prairie States Life Ins. Co.* v. *United States,* 828 F.2d 1222 (1987), and with the Fifth Circuit's decision in *Colonial American Life Ins. Co.* v. *Commissioner,* 843 F.2d 201 (1988), cert. granted, No. 88-396 (Dec. 5, 1988) (App., *infra,* 11a-15a), the court held that the ceding commissions in this case were currently deductible. The court of appeals thus accepted the distinction between indemnity reinsurance transactions and assumption reinsurance transactions subscribed to by the Tax Court, concluding that ceding commissions paid pursuant to indemnity reinsurance agreements, like agents'

commissions paid pursuant to the issuance of a new insurance policy, were intended by Congress to be currently deductible (see *id.* at 13a-14a). The court acknowledged that there is some similarity between assumption and indemnity reinsurance, but it concluded that the "differences substantially outweigh the similarities," and that different treatment of the two kinds of transactions is therefore justified (*id.* at 15a).

REASONS FOR GRANTING THE PETITION

This case presents the same question pending before the Court in *Colonial American Life Ins. Co.* v. *Commissioner,* cert. granted, No. 88-396 (Dec. 5, 1988), concerning the correct tax treatment of ceding commissions paid in connection with indemnity reinsurance transactions. For the reasons stated in our response to the petition for a writ of certiorari in *Colonial,* we believe that the court below erred in holding that such ceding commissions are currently deductible, in contrast to ceding commissions paid in connection with assumption reinsurance transactions. Because the two cases present identical legal questions, the outcome here should be controlled by the result in *Colonial,* and there is no need for this Court to grant plenary review in this case. It would therefore be appropriate for the Court to hold this case pending the outcome in *Colonial,* and to dispose of the petition accordingly.

CONCLUSION

The petition for a writ of certiorari should be disposed of as appropriate in light of this Court's decision in *Colonial American Life Insurance Co.* v. *Commissioner,* No. 88-396.

Respectfully submitted.

CHARLES FRIED
Solicitor General

DECEMBER 1988

APPENDIX A

IN THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

No. 87-2129

MERIT LIFE INSURANCE COMPANY, PETITIONER-APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLANT

Appeal from the Decision of the
United States Tax Court.
No. 13441-78—Julian I. Jacobs, *Judge.*

Argued January 21, 1988
Decided August 11, 1988

Before CUMMINGS, WOOD, JR., *Circuit Judges,* and WILL, *Senior District Judge.**

WILL, *Senior District Judge.* This appeal involves the tax consequences of a general practice in the insurance industry called reinsurance. For any number of reasons, insurance companies transfer all or part of the risk of a

* The Honorable Hubert L. Will, Senior Judge of the United States District Court for the Northern District of Illinois, Eastern Division, is sitting by designation.

block of policies, under which they are the original insurer, to another insurance compay, the reinsurer, in exchange for, among other things, a commission. The original insurer is known as the reinsured or ceding company and commissions paid by the reinsurer (or retained by the reinsured) are called ceding commissions. There are two general types of reinsurance: indemnity and assumption. At issue is the tax treatment for ceding commissions in indemnity reinsurance transactions.

In indemnity reinsurance, the ceding company does not relinquish any of its contractual interest in the policies it issued and remains directly liable to the policy holders. No relationship, contractual or otherwise, exists between the reinsurer and the policy holders. The ceding company pays the reinsurer a percentage of the premiums it received, upon issuance of the policies, proportional to the risk assumed by the reinsurer, which may be part or all of the total risk. The ceding company continues to pay claims and expenses and collect premiums, and pays the reinsurer a percentage of the future premiums again based on the risk transferred. In exchange, the reinsuring company reimburses (indemnifies) the ceding company for its share of the claims and expenses attributable to the risk reinsured and pays (or the ceding company retains) a ceding commission.

State laws and regulations require that an insurance company maintain a reserve, in cash or other assets, reflected as a liability for accounting purposes, representing the excess of the present value of future benefits payable under the life insurance policy over the present value of future net premiums received. The amount of the reserve changes over the life of a policy and the reserve may not be used for other corporate purposes, such as distributing dividends to shareholders. However, the reserve may be invested to produce interest income. Indemnity reinsur-

ance reduces the reserve required of the ceding company and increases the reserve required of the reinsurer, based on the proportion of the risk transferred to the reinsurer.[1]

In contrast, assumption reinsurance involves the purchase of a block of insurance policies by the reinsurer from the original insurer at which point the reinsurer assumes *all* of the original insurer's risks and obligations and becomes directly liable to the policy holders. The original insurer is then relieved of all liability under the policies and the policy holders are informed that henceforth they are insured by the reinsuring company and all future premiums are to be paid and claims made to the reinsurer. The reinsurer pays all future claims, commissions, expenses and taxes. In addition, the reinsurer assumes the entire reserve liability, thereby reducing the ceding company's reserve liability. The purchase price is normally greater than but includes a commission to the selling company. The reinsurer simply purchases the policies and steps into the shoes of the ceding or selling company.

This case involves indemnity reinsurance. Merit Life Insurance Company ("Merit"), petitioner-appellee, an Indiana corporation, reinsured (agreed to indemnify) specified percentages, but not 100%, of five blocks of insurance policies, four of which were originally insured by American General Life Insurance Company of Delaware

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[1] The indemnity reinsurance described above is specifically known as conventional indemnity reinsurance. There is another type of indemnity reinsurance called modified coinsurance in which the ceding company continues to hold the entire reserve, but pays the reinsurer any investment income attributable to the assets supporting the reserve. The two companies, however, may consent, pursuant to 26 U.S.C. § 820(a), to have the tax consequences for each company be the same as if the reinsurer was maintaining the reserve in the case of conventional indemnity reinsurance. In effect, the reinsured maintains the reserve as a custodian on behalf of the reinsurer.

and one by American General Life Insurance Company of New York (both original insurers are hereinafter referred to as "American General"). American General paid "reinsurance premiums" to Merit, in an amount equal to the reserves Merit was required to carry on the policies less ceding commissions payable to Merit to American General.[2]

In addition, under the terms of the contracts, American General agreed to transfer a specified percentage of the gross premiums thereafter received on the reinsured policies and Merit agreed to pay American General for its share of commissions, premium taxes and other expenses incurred by American General. Finally, each contract provided that American General could recapture the reinsured policies on specific dates.

During the tax years in question, 1973-75, Merit claimed a tax loss under 26 U.S.C. § 809(b) (section 809(b) of "the

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[2] Two of the five reinsurance transactions at issue here are modified coinsurance transactions but Merit and American General employed section 820(a) for tax purposes. Consequently, the same tax result applies as if all five transactions were conventional indemnity reinsurance transactions, and, for convenience, we will refer to all five as indemnity reinsurance transactions.

One of the three conventional coinsurance agreements specified that American General agreed to pay Merit a reinsurance premium equal to the reserve liability on the block of policies and Merit in turn agreed to pay a ceding commission which American General offset against the reinsurance premium. The other two conventional coinsurance agreements only provide for the payment of a reinsurance premium. It is understood, however, that the reinsurance premium with respect to these two agreements represents the reserve liability less a ceding commission. Thus, all five transactions are treated as conventional indemnity reinsurance transactions which result in an actual money transfer from American General to Merit of a reinsurance premium less a ceding commission.

Code"),[3] on each of the indemnity reinsurance contracts because the reserves required and expenses incurred with respect to each contract exceeded the reinsurance premiums Merit received from American General. Specifically, Merit recognized as gross income the consideration (reinsurance premiums) deemed received from American General for assuming reserve liabilities, pursuant to section 809(c)(1), and deducted the same amount as the reserve liability, pursuant to section 809(d)(2). Merit also deducted the ceding commissions paid to (or retained by) American General from its gross premiums (gross income), pursuant to section 809(c)(1).[4] Since these amounts exceeded the gross premiums, Merit reported a loss for the transactions which it used to offset gains from other operations during those years.

The Commissioner of Internal Revenue ("Commissioner"), respondent-appellant, found deficiencies in Merit's declared federal income taxes based on Merit's *current* deduction of all the ceding commissions in the tax years in

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[3] The years in issue are governed by the Internal Revenue Code of 1954 and the Life Insurance Company Income Tax Act of 1959, 26 U.S.C. §§ 801-820.

[4] Section 809 provides the following in relevant part:

(c)(1) *Premiums.* – The gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts (including contracts supplementary thereto); *less return premiums, and premiums and other consideration arising out of reinsurance ceded.* . . .

(d) *Deductions.* – For purposes of subsections (b)(1) and (2), there shall be allowed the following deductions:

(2) *Increase in certain reserves.* – The net increase in reserves which is required. . . .

26 U.S.C. § 809 (emphasis added).

which it issued the indemnity reinsurance.[5] The Commissioner determined that the ceding commissions must be *amortized* over the anticipated lives of the reinsurance contracts (between 57 and 64 months) because, according to the Commissioner, the reinsurance contracts are intangible assets with useful lives or more than one year.[6]

Merit petitioned the United States Tax Court for a redetermination of the deficiencies. The case was submitted to the Tax Court without a trial and resolved based on the parties' stipulated facts and exhibits. The Tax Court, relying on its earlier opinion in *Beneficial Life Insurance Co. v. Commissioner*, 79 T.C. 627 (1982), reversed the Commissioner and held that in indemnity reinsurance arrangements the ceding commissions are deductible in full in the year in which the indemnity reinsurance is issued. *Merit Life Insurance Company v. Commissioner of Internal Revenue*, 52 T.C.M. (CCH) 638 (1987).

The Tax Court reaffirmed its view that an indemnity reinsurance transaction is not the purchase of an asset, but rather the sale of insurance by the reinsuring company to the ceding company. Accordingly, the Tax Court, as it had in *Beneficial Life*, viewed the ceding commissions paid by the reinsuring company (or retained by the reinsured) as analogous to currently deductible underwriting expenses such as agents' commissions paid by an original insurer on the issuance of a policy and reversed the Commissioner's

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[5] The Commissioner also found a deficiency in Merit's 1972 tax return. The issues with respect to 1972, however, were settled and are not before us.

[6] Under the contracts between Merit and American General, American General had the right to reacquire the insurance business on a scheduled basis, ranging from 57 to 64 months after the issuance of the reinsurance.

disallowance of their deduction. The Commissioner appeals the Tax Court's ruling. We affirm.

Standard Of Review

As noted above, the Tax Court's decision was based on stipulated facts and exhibits. The court's holding that the ceding commissions in an indemnity reinsurance transaction are immediately deductible, based on uncontested facts, is a conclusion of law. Accordingly, we review the record *de novo. United Fire Insurance Company v. Commissioner of Internal Revenue,* 768 F.2d 164, 167 (7th Cir. 1985). *See also Vukasovich, Inc. v. Commissioner of Internal Revenue,* 790 F.2d 1409, 1413 (9th Cir. 1986) ("A general rule of special deference to the Tax Court is inappropriate although its judgments in its field of expertise are always accorded a presumption that they correctly apply the law."); 26 U.S.C. § 7482(a) (1982).

Analysis

The Commissioner asked the Tax Court and now asks us to reconsider *Beneficial Life.* The Tax Court in *Beneficial Life* distinguished indemnity reinsurance from assumption reinsurance by deeming the former to be the "issuance of insurance," for which ceding commissions are immediately deductible, and the latter to be the "acquisition of an asset," for which ceding commissions must be amortized. 79 T.C. at 648. The Commissioner acknowledges that the distinction between assumption and indemnity reinsurance is significant to the policy holders and the ceding company but argues that it does not alter the reinsurer's position and should not create distinct tax consequences. According to the Commissioner, in both cases the reinsurer pays consideration (ceding commissions) for the right to receive future profits (reinsurance premiums)

and, following the tax principle of matching expenses incurred (year by year) with income generated, *see Commissioner v. Idaho Power Co.*, 418 U.S. 1, 12 (1974), the consideration must be amortized.

Merit argues that indemnity and assumption reinsurance are different and must be treated differently for tax purposes. It points out that the Code specifically treats both differently and the Tax Court recognized this in *Beneficial Life*. Although this distinction may not achieve a direct matching of income and expenses for tax purposes, the Code and treasury regulations provide for it. The same is true, it should be noted, as to the deduction of all commissions paid on the sale of insurance.

The court in *Beneficial Life* specifically rejected the Commissioner's argument that ceding commissions in indemnity reinsurance transactions must be amortized:

> Respondent [Commissioner] cites to us numerous cases which required capitalization and amortization of acquisition expenses. However, such cases apply when an asset is acquired, not when insurance is sold. Although a reinsuring company does acquire an asset in a broad sense in the form of potential future profit, such is also true when an insurance company issues a single policy to an individual. Yet, the expenses related to that policy are currently deductible. While respondent's argument is appealing, it does not comport with how life insurance companies are taxed with respect to insurance they issue. *In essence, respondent argues indemnity reinsurance should be taxed as is assumption reinsurance; yet the Code treats one as the issuance of insurance and one as acquisition of an asset. That makes all the difference.*

79 T.C. at 647-48 (emphasis added).

The Tax Court's reasoning in *Beneficial Life* is supported by the explicit language in section 809(c)(1) and the applicable treasury regulations. Section 809(c)(1) provides that an insurance company's gross income equals "the gross amount of premiums and other consideration . . . less return premiums, and premiums and other consideration arising out of reinsurance ceded." *See* note 4 *supra*. Under section 809(c)(1), "reinsurance ceded" includes commissions from indemnity reinsurance transactions but not from assumption reinsurance transactions.

> (iii) For purposes of section 809(c)(1) and this subparagraph, the term "reinsurance ceded" means an arrangement whereby the taxpayer (the reinsured) remains solely liable to the policyholder, whether all or only a portion of the risk has been transferred to the reinsurer. *Such term includes indemnity reinsurance transactions but does not include assumption reinsurance transactions.* See paragraph (a)(7)(ii) or section 1.809-5 for the definition of assumption reinsurance.

Treas. Reg. § 1.809-4(a)(1)(iii) (emphasis added).

> (ii) For purposes of section 809(d)(7) and this subparagraph, the term "assumption reinsurance" means an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the taxpayer. *Such term does not include indemnity reinsurance* or reinsurance ceded (as defined in paragraph (a)(1)(iii) or section 1.809-4).

Treas. Reg. § 1.809-5(a)(7)(ii) (emphasis added). *See also* S. Rep. No. 291, 86th Cong., 1st Sess., at 54 (1959), *reprinted in* 1959 U.S. Code Cong. & Ad. News 1575; 1959-2 C.B. 770, 809. In contrast, ceding commissions paid in an assumption reinsurance transaction must be amortized:

> (2)(ii) In connection with an assumption reinsurance . . . transaction, a reinsurer shall . . .
>
> (B) Treat any amount paid to the reinsured for the purchase of such contracts, . . . , as a deferred expense that may be amortized over the reasonably estimated life . . . of the contracts reinsured and treat the portion of the expense so amortized in each taxable year as a deduction under section 809(d)(12) irrespective of the taxable year in which such amount was paid to the reinsured.

Treas. Reg. § 1.817-4(d)(2)(ii)(B).

The Commissioner contends that "reinsurance ceded" under section 809(c)(1) refers only to the reinsured or ceding company and not to the reinsurer. There is no provision, however, in section 809 of the applicable treasury regulations which even remotely suggests the Commissioner's interpretation or distinction. In addition, the term "return premiums" is defined in the regulations as follows:

> (ii) The term "return premiums" means amounts returned or credited which are fixed by contract and do not depend on the experience of the company or the discretion of the management. Thus, such term includes amounts refunded due to policy cancellations or erroneously computed premiums. *Furthermore, amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded shall be included in return premiums.* . . .

Treas. Reg. § 1.809-4(a)(1)(ii) (emphasis added). Moreover, section 809(c)(1) provides for a *deduction* of ceding commissions from gross premiums earned. A ceding company *adds* ceding commissions to gross income. For the ceding company, ceding commissions represent income, not expenses (which are deducted). On the other hand, for

the reinsuring company, indemnity reinsurance ceding commissions represent a current expenses which would normally be deductible as are commissions paid to a salesperson upon the sale of a policy or when premiums are received in subsequent years. *Beneficial Life,* 79 T.C. at 646.

The Court of Appeals for the Fifth Circuit, in an opinion decided after the oral argument in our case, adopted the Commissioner's position that ceding commissions in indemnity reinsurance contracts must be amortized over the anticipated life of the reinsurance contract.[7] *Colonial American Life Insurance Company v. Commissioner,* 843 F.2d 201 (5th Cir. 1988). The Fifth Circuit held that "without a clear difference in the statute [Code] for treatment of assumption reinsurance contracts and indemnity reinsurance contracts, we must apply [the] 'general' tax rule" which matches income and expenses such that expenses incurred to acquire a capital asset (in general, one with a useful life greater than one year) must be amortized over the expected life of the asset. 843 F.2d at 204. The Fifth Circuit embraced the Eighth Circuit's reasoning in *Modern American Life Insurance Co. v. Commissioner,* 818 F.2d 1386 (8th Cir. 1987) and *Prairie States Life Insurance Co. v. United States,* 828 F.2d 1222 (8th Cir. 1987).

The Court of Appeals for the Eighth Circuit in *Modern American* held that ceding commissions in modified coinsurance transactions, where no section 820 election is made, *see* note 1 *supra,* reflect acquisition costs of capital assets which must be amortized. The *Modern American* court, however, distinguished the contract at issue there

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[7] The contracts at issue in *Colonial American* involved both conventional and modified indemnity reinsurance transactons but, as in our case, the parties consented to the optional tax treatment under section 820(a) with respect to their modified indemnity reinsurance transactions and, thus, the reinsurance transactions presented there are the same as those in our case.

from the modified coinsurance transactions at issue in *Beneficial Life,* in which section 820 elections were made. 818 F.2d at 1389. ("The facts of *Beneficial Life* are therefore not before us, and thus we express no opinion as to the correctness of the result in that case.").[8]

Merit argues that this distinction renders *Modern American* irrelevant to our case. In response, the Commissioner argues that, notwithstanding the Eighth Circuit's statement to the contrary, a section 820 election has no bearing on the tax treatment of ceding commissions. Because a section 820 election was made in our case, we need not express an opinion on the distinction, if any, between modified indemnity reinsurance transactions where a section 820 election is not made and a modified indemnity reinsurance transaction where a section 820 election is made, with respect to the tax treatment of ceding commissions.

The Eighth Circuit in *Prairie States* was presented with conventional indemnity reinsurance contracts and the court found no distinction between modified indemnity reinsurance where no section 820 election is made (the facts in *Modern American*) and conventional reinsurance with respect to the tax treatment of ceding commissions. More importantly, the court equated conventional reinsurance with assumption reinsurance and reasoned that both involve the acquisition of a capital asset and because ceding commissions must be amortized in assumption (purchase) reinsurance transactions, ceding commissions must also be amortized in indemnity (non-purchase) reinsurance transactions.

> It makes no difference that in this transaction, unlike the one in *Modern American,* there is income from which taxpayer could in theory deduct the commis-

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[8] *Beneficial Life* also involved conventional indemnity reinsurance and assumption reinsurance transactions.

> sion as a 'return premium.' The real issue, and the one decided in *Modern American* with respect to modified coinsurance, is whether Section 809(c)(1) should be read to permit taxpayer to treat as an immediate reduction of income during the taxable year the cost of acquiring in a conventional coinsurance arrangement an intangible asset 'with an income-producing life extending substantially beyond the taxable year.' [*Modern American,* 830 F.2d] at 114. We hold that Section 809(c)(1) should not be so read.
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> * * * * *
>
> [W]e do not believe that Congress intended to treat a ceding commission of the kind here at issue as a currently deductible underwriting expense analogous to an agent's commission paid by a direct insurer. . . . [T]he commission represents a one-time payment for the acquisition of an economic interest in a block of previously issued policies.

828 F.2d at 1233-34.

The Commissioner and the Courts of Appeals for the Fifth and Eighth Circuits fail to recognize the inherent distinctions between assumption and indemnity reinsurance transactions and the legal distinctions provided by the Code and the treasury regulations cited above. From the reinsuring company's perspective, indemnity reinsurance is not an acquisition of an intangible asset with a useful life of more than one year. By its nature, an indemnity reinsurance transaction is, from the perspective of the reinsurer, simply an indemnity or co-insurance arrangement, in substance, the sale of an insurance policy by the reinsurer to the ceding company. Economically, it is substantially the same as the sale of any other policy. In contrast, assumption reinsurance is by its nature the purchase of already issued insurance policies and the elimina-

tion of any participation or interest of the selling or ceding company.

The improper characterization of indemnity reinsurance transactions by the Fifth and Eighth Circuits and the Commissioner contributed to their misunderstanding and misinterpretation of the Code and application of the treasury regulations. In addition to embracing the Eighth Circuit's reasoning in *Modern American* and *Prairier States,* the Fifth Circuit in *Colonial American* also adopted the same rationale for indemnity reinsurance transactions as it had previously for assumption reinsurance transactions. 843 F.2d at 205, *citing Southwestern Life Ins. Co. v. United States,* 560 F.2d 627, 640-41 (5th Cir. 1977), *cert. denied,* 435 U.S. 995 (1978).

Interestingly, the Fifth Circuit in *Southwestern Life* held that "equat[ing] the current deductibility of commissions paid in the life insurance industry to agents who put new policies on the books of the company with the payment of $9,800,000 for the acquisition of some 100,000 outstanding policies is not an apt comparison." 560 F.2d at 641. That reasoning is, of course, consistent with the distinctions made by the Code and recognized and applied in *Beneficial Life* to assumption reinsurance, the type of reinsurance before the court in *Southwestern Life.* It does not follow, however, that the cost of acquiring already existing insurance policies, as in the case of assumption reinsurance, should be equated with the expenses incurred in what amounts to the sale of new insurance policies, as in the case of indemnity reinsurance. Moreover, the Code, treasury regulations and legislative history recognize that indemnity reinsurance and assumption reinsurance are to be treated differently with respect to the tax treatment of ceding commissions paid.

The Eighth Circuit also equated indemnity reinsurance with assumption reinsurance, even after recognizing that

the Code and treasury regulations distinguish between the two transactions. Indeed, after noting that assumption reinsurance is "explicitly governed by Treas. Reg. § 1.817-4(d)," the court in *Prairie States* claimed that section 1.817-4(d)(2)(iii) "specifically covers transactions *similar* to the one in this case, 'where the reinsured transfers to the reinsurer in connection with [an] *assumption reinsurance transaction* a net amount which is less than the increase in the reinsurer's reserves resulting from the transaction." 828 F.2d at 1230 (emphasis added). While there is some similarity between assumption and indemnity reinsurance, the differences substantially outweigh the similarities and to equate the tax treatment of the two transactions based on their similarities is improper, especially in light of the fact that section 1.817-4(d)(2)(iii) applies specifically only to assumption reinsurance.

The court in *Prairie States* later acknowledged that section 1.817-4(d)(2)(ii) "by its terms applies only to assumption reinsurance transactions. Moreover, the definition of assumption reinsurance, contained in Treas. Reg. § 1.809-5(a)(7)(ii), specifically excludes indemnity reinsurance." 828 F.2d at 1232. Notwithstanding, the court found that the "principles" behind the tax provisions for assumption reinsurance (illustrated in the treasury regulations), should also control the tax treatment of ceding commissions in indemnity reinsurance transactions. *Id.* We disagree.

The current deduction of agents' commissions by *direct insurers* is provided for in the Code. In addition, the legislative history surrounding the Deficit Reduction Act of 1984 ("DEFRA"), although not controlling, recognized and strengthened this provision.

> The change [DEFRA] from present law [1959 Act] was intended to reinforce the primacy of the Federal tax rules and not impose a new method of tax ac-

> counting on life insurance companies. Thus, for example, agents' commissions paid by direct insurers would continue to be treated as sales expenses and deductible when paid, as has been allowed historically (even though they arguably might be classified as acquisition expenses to be amortized).

H.R. Rep. No. 432, 98th Cong., 2d Sess., pt. 2, at 1428 (1984), *reprinted in* 1984 U.S. Code Cong. & Admin. News 697, 1073; Senate Comm. On Finance. S. Prt. No. 169 (Vol. I), 98th Cong., 2d Sess., at 555 (1984). Because substantively indemnity reinsurance is the sale of insurance by the reinsurer to the ceding company, it follows that, in addition to the explicit provisions of the Code and treasury regulations, the principles governing the sale of insurance, in the case of direct insurers, also apply to indemnity reinsurers.

Merit argues that reinsurance is just what it sounds like: insured insurance. Whether or not an insurance company sells insurance to an individual or to another insurance company, each involves the issuance of new policies and the transfer of a risk and, under the Code, the commission expenses incurred in either transaction, whether paid to insurance agents in the case of individual policies or to ceding companies in the case of reinsurance, are deductible in the year of their payment. The Commissioner does not dispute that commissions paid to agents in connection with the sale of individual insurance policies by an original insurer are currently deductible in the year of the transaction.

The Court of Appeals for the Ninth Circuit recently distinguished assumption reinsurance from indemnity reinsurance with respect to the tax treatment of ceding commissions. *Oxford Life Insurance Company v. United States,* 790 F.2d 1370 (9th Cir. 1986). Although that case

involved assumption reinsurance, the court emphasized its holding by making the following comparison between both reinsurance transactions:

> Assumption reinsurance transactions receive different treatment in the Tax Code from that accorded indemnity reinsurance transactions because of the transfer of assets. An assumption reinsurance transaction is treated as a sale of policies; an indemnity reinsurance transaction is the purchase of insurance protection [by] the reinsured. *Beneficial Life,* 79 T.C. at 645-46.
>
> * * * * *
>
> The exception created in the statute for 'reinsurance ceded' specifically refers to indemnity reinsurance. Treas. Reg. § 1.809-4(a)(1)(iii); S. Rep. No. 291, 86th Cong., 1st Sess. at 54 (1959-2 Cum.Bull. 809). Thus, indemnity reinsurers may subtract from income any consideration returned to the ceding company with respect to the reinsurance ceded. *Beneficial Life,* 79 T.C. at 646. . . . While the [treasury] regulation notes that the definition of return premiums is specifically broadened in the case of indemnity reinsurers, *see* Treas. Reg. §§ 1.809-4(a)(1)(ii) and (iii), assumption reinsurers, as noted earlier, receive different treatment in the tax code. *See Beneficial Life,* 79 T.C. at 646-47.

790 F.2d at 1376. In addition to those provisions of the Code cited above, other provisions draw distinctions between indemnity and assumption reinsurance. *See* 26 U.S.C. §§ 806,[9] and 809(d)(7).[10]

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[9] 26 U.S.C. § 806(a) provides in relevant part:

> . . . if, during the taxable year, there is a change in life insurance reserves attributable to the transfer between the taxpayer and another person of liabilities under contracts taken into account in

The Court of Appeals for the Second Circuit has affirmed the Tax Court's ruling concerning a life insurance company's deductions under section 809(d)(5) for increases in reserves for "certain nonparticipating contracts." *Cologne Life Reinsurance Co. v. Commissioner,* 80 T.C. 859 (1983), *aff'd by summary order,* 732 F.2d 141 (2nd Cir. 1984) (unpublished opinion). Although dicta, the Tax Court in *Cologne* began its discussion by distinguishing between assumption and indemnity reinsurance transactions. 80 T.C. at 862 ("[T]he issuance of indemnity life reinsurance is treated generally as the issuance of life insurance."), *citing Beneficial Life,* 79 T.C. at 647-48.

Congressional history supports the similar tax treatment for indemnity reinsurance and directly-written insurance contracts, with respect to the deduction of expenses (and consequently a dissimilar tax treatment than for assumption reinsurance):

> Modified coinsurance is a form of indemnity reinsurance (as contrasted to assumption reinsurance) to indemnify an insurer against a risk it has assumed. . . . Three forms of this indemnity reinsurance have been developed. The first of these, called coinsur-

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computing such reserves, then, . . . , the means of such reserves, and the means of the assets, shall be appropriately adjusted, on a daily basis, to reflect the amounts involved in such transfer. This subsection shall not apply to reinsurance ceded to the taxpayer or to another person.

[10] Section 809(d)(7) provides the following in relevant part:

(d) *Deductions.* – For purposes of subsections (b)(1) and (2), there shall be allowed the following deductions:

(7) *Assumption By Another Person Of Liabilities Under Insurance, Etc., Contracts.* – The consideration (other than consideration arising out of reinsurance ceded) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto).

> ance, calls for the premium with respect to the insurance reinsured to go to the reinsurer, with the result that *the reinsurer, with respect to this insurance, is treated substantially in the manner he would be if he had issued the insurance policy (or part thereof) directly.* Any expenses incurred by the initial insurer with respect to the policy are reimbursed by the reinsurer. This form of indemnity reinsurance presents few special tax problems.

S. Rep. No. 291, 86th Cong., 1st Sess., at 38-39 (1959), *reprinted in* 1959 U.S. Code Cong. & Admin. News 1575, 1959-2 C.B. 770, 797-798 (emphasis added). Had Merit acted as the original insurer with respect to the policies in these contracts, rather than as a reinsurer, it would have incurred an underwriting loss because the reserves required and expenses incurred generally exceeded the premiums received during the year the insurance was issued. Brief of *Amici Curiae* at 5.

In addition, legislative descriptions of recent revisions to the Code, although not controlling here, are indicative of the distinctions between indemnity and assumption reinsurance.

> Whereas an indemnity reinsurance contract describes a continuing insurance relationship between the ceding company and the reinsurer, an assumption reinsurance contract is considered a sale of a block of business.

General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, prepared by the Staff of the Joint Committee on Taxation, at 633 (Dec. 31, 1984). This explanation is verbatim from a Technical Advice Memorandum prepared by the Commissioner just prior to the Commissioner's appeal in this case. Tech. Adv. Mem. 87-42-004 (June 30, 1987). *See* Brief of *Amici Curiae* at n. 13.

Finally, the Commissioner claims that generally accepted accounting principles ("GAAP") hold that ceding commissions in indemnity reinsurance transactions should be amortized as an acquisition expense and, thus, tax accounting should employ the same treatment. Respondent-Appellant's Brief at n. 22.[11] The difficulty with that contention is that GAAP would only control the deduction of ceding commissions if the Commissioner's basic assumption were correct: that *indemnity reinsurance* transactions represent the acquisition of a capital asset. That assumption is, however, erroneous.

In addition, the Supreme Court has expressed a preference for the accounting rules and procedures of the National Association of Insurance Companies ("NAIC"). The Court has interpreted 26 U.S.C. § 818(a) as providing that the tax liability for insurance companies is to be computed consistent with the NAIC's rules except where "accrual accounting dictate[s] a contrary result, . . ." *Commissioner v. Standard Life and Accident Insurance Company,* 433 U.S. 148, 159 (1977).[12] Because generally accepted ac-

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[11] Treas. Reg. § 1.461-1(a)(2) provides:

(2) *Taxpayer using an accrual method.*—Under an accrual method of accounting, an expense is deductible for the taxable year in which all events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred.

[12] 26 U.S.C. § 818(a) provides the following:

(a) Method of Accounting.—All computations entering into the determination of the taxes imposed by this part shall be made—

(1) under an accrual method of accounting, or

(2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method

counting principles (accrual accounting) do not control the tax treatment for ceding commissions in indemnity reinsurance transactions, we must consider the NAIC's rules. Both parties agree that Merit's current deduction of ceding commissions followed the accounting rules for life insurance companies established by the NAIC.

Allowing insurance companies to immediately deduct ceding commissions for indemnity reinsurance but not for assumption reinsurance reflects the inherent differences between the two transactions and the complexities of the insurance industry.

> We realize that it may seem strange at first for the assumption reinsurance transaction and the indemnity reinsurance transactions at issue herein to have such different tax consequences when they are, at heart, so similar. An understanding of that difference must flow from the understanding of the complex and somewhat unique rules applicable to the insurance industry. . . .
>
> * * * * *
>
> . . . [R]eserves are deduction when set up and when added to; premiums are income as received; . . . and, decreases in reserves give rise to income. Additionally, an insurance company may deduct currently expenses such as commissions, taxes, and underwriting expenses. It is within that framework that indemnity reinsurance, as the reinsurer's sale of insurance, falls. In essence, the allowance paid the ceding company is

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of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method). Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

> analogous to currently deductible underwriting expenses.

Beneficial Life, 79 T.C. at 646-47 (citation and footnote omitted).

If American General had withheld or deducted the ceding commissions from the reinsurance premiums prior to paying them to Merit, without specifically referring to "ceding commissions" in the agreements, the tax consequences would have been exactly the same as the Tax Court has held: Merit's taxable income would have been reduced by the ceding commissions in the year in which the reinsurance was issued. Merit's gross income would automatically have been reduced. Gross income reflects actual consideration received and this would have been reduced by the withheld amounts, thus producing the same net loss. Merit would not have had to subtract ceding commissions from the reinsurance premiums it received. In fact, it appears that two of the five agreements were structured in this manner. *See* note 2 *supra*.

Alternatively, Merit claims that ceding commissions are deductible under sections 162 and 809(d)(12) as one of many "other deductions" or ordinary business expenses. The Tax Court in *Beneficial Life* noted that ceding commissions in indemnity reinsurance transactions are analogous to currently deductible underwriting expenses of a direct insurer. 79 T.C. at 647. Those deductions are made pursuant to section 809(d)(12).[13] Because we hold that

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[13] Section 809(d)(12) provides the following in relevant part:

> (d) *Deductions.*—For purposes of subsections (b)(1) and (2), there shall be allowed the following deductions:
>
> (12) *Other Deductions.*—. . . , all other deductions allowed under this subtitle for purposes of computing taxable income to the extent not allowed as deductions in computing investment yield.

ceding commissions are deductible from gross premiums under section 809(c)(1), we need not address Merit's alternative argument, although we agree with the Tax Court's analogy.

Conclusion

In sum, we conclude that the Code, treasury regulations and legislative history support the petitioner's position and the Tax Court's holding that ceding commissions paid by a reinsuring company or retained by the reinsured company, in an indemnity reinsurance transaction or in a modified indemnity reinsurance transaction in which both insurance companies have consented to treat the transaction as a conventional indemnity reinsurance transaction pursuant to 26 U.S.C. § 820(a), are immediately deductible by the reinsurer in the year in which the reinsurance is issued.

The opinion of the Tax Court is

AFFIRMED.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
CHICAGO, ILLINOIS 60604

No. 87-2129

MERIT LIFE INSURANCE COMPANY, PETITIONER-APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLANT

Appeal from the United States Tax Court

August 11, 1988

Before
Hon. WALTER J. CUMMINGS, Circuit Judge
Hon. HARLINGTON WOOD, JR., Circuit Judge
Hon. HUBERT L. WILL, Senior District Judge.*

JUDGMENT ORDER

This cause was heard on the record from the United States Tax Court, and was argued by counsel.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the decision of the Tax Court is AFFIRMED, with costs, in accordance with the opinion of this Court filed this date.

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* The Honorable Hubert L. Will, Senior Judge, United States District Court for the Northern District of Illinois, sitting by designation.

APPENDIX C

UNITED STATES TAX COURT

Docket No. 13441-78

MERIT LIFE INSURANCE COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Filed September 25, 1986

Bernard J. Schoenberg and *Michael Neil Gendelman,* for the petitioner.

Seymour I. Sherman, for the respondent.

MEMORANDUM OPINION

JACOBS, *Judge:* Respondent determined deficiencies in petitioner's Federal income taxes as follows:

Year	Deficiency
1972	$ 30,867.22
1973	344,269.10
1974	388,015.09
1975	681,259.08

After concessions, the only issue for decision involves the current deductibility vis-a-vis the amortization of ceding commissions paid in coinsurance transactions. Petitioner, the reinsuring company in five coinsurance transactions, contends that it may currently deduct the ceding commissions which it paid to (or which were retained by) the ceding company. Respondent contends that such commis-

sions must be amortized over the anticipated lives of the reinsured insurance policies.

The facts of this case have been fully stipulated pursuant to Rule 122[1] and are so found. Petitioner, an Indiana corporation organized in 1957, had its principal place of business in Evansville, Indiana at all relevant times, including the date its petition was filed.

Petitioner engaged in the insurance business in Indiana and in numerous other states; its principal insurance risks during the years in issue consisted of life contingencies originally written by it and the reinsuring of policies written by other insurance companies.

When a company issues a policy or contract of permanent life insurance, it must thereafter reflect as a liability, designated by the term "reserve", the excess of the then present value of future benefits payable under the policy over the then present value of future net premiums to be received, computed as applicable state laws or regulations prescribe. The required reserve amount constitutes a liability against which the company must maintain cash or other assets. Further, the reserve amount reduces the surplus of the company available for general corporate purposes, including distributions to shareholders.

Reinsurance is an arrangement whereby an insurance company transfers some or all the risks it has underwritten to another insurance company. The company transferring the risk is known as the ceding or reinsured company; the company acquiring the risk is know as the assuming or reinsuring company or simply the reinsurer. One significant effect of a reinsurance transaction is to release the reserves (and thus restore or increase the surplus) of the ceding company.

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[1] All Rule references are to the Tax Court Rules of Practice and Procedure. All section references are to the Internal Revenue Code of 1954, as amended and as in effect during the taxable years in issue.

Reinsurance transactions may be classified into two cateogries: (1) assumption reinsurance,[2] and (2) coinsurance, which is also known as indemnity reinsurance. This case involves only coinsurance transactions.

In a coinsurance transaction, the ceding company transfers to the reinsuring company all or part of its liability on the reinsured policies, but it remains directly liable to the policyholders, collects premiums, and pays claims and expenses.[3] The ceding company reduces its reserves attributable to the transferred liabilities, and the reinsuring company increases its reserves to cover the acquired risk. The reinsuring company pays the ceding company a commission for the reinsured insurance policies. The net re-

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[2] In assumption reinsurance, the ceding company transfers some or all of its policies to the reinsuring company. The reinsuring company steps into the ceding company's shoes, and becomes directly liable to the policyholders. The reinsuring company also assumes, with respect to the policies transferred, the reserve liability and entitlement to all future premiums. Correlatively, the ceding company is relieved of the reserve liability and, accordingly, reduces its required reserves. *Beneficial Life Insurance Company v. Commissioner*, 79 T.C. 627 (1982).

[3] Modified coinsurance is a type of coinsurance which differs from conventional coinsurance in that the ceding company retains the reinsured assets, continues to carry the reserves on its books and collects any investment income derived from assets supporting the reserves. However, if the parties consent under section 820(a), the ceding company's retention of assets and corresponding reflection of reserves are treated for tax purposes as being merely custodial for the reinsuring company's behalf. Consequently, the same transfer of reserves from the ceding company to the reinsuring company takes places as in conventional coinsurance. Although two of the transactions herein were modified coinsurance transactions, the parties made the applicable consent under section 820(a); for tax purposes, then, the same results obtain as if conventional coinsurance had been used. Therefore, we will use the generic term, coinsurance, to describe all the transactions herein.

sult is that the reinsuring company assumes a reserve liability in excess of the consideration actually received from the ceding company.

Petitioner entered into five reinsurance transactions from September, 1973 through December, 1975 with American General Life Insurance Company of Delaware, or with American General Life Insurance Company of New York (both of these companies herein are referred as to American General). In each transaction, petitioner reinsured, on a coinsurance basis, life insurance policies originally written by American General. The required increase in petitioner's reserves, the total consideration received from American General and the ceding commission paid to (or retained by) American General in each transaction were as follows:

1. Transaction date: September 1, 1973	
Required increase in reserves	$ 6,548,458
Consideration from American General	$ 5,133,991
Ceding Commission *retained* by American General	$ 1,414,467
2. Transaction date: April 1, 1974	
Required increase in reserves	$ 5,516,712
Consideration from American General	$ 5,516,712
Ceding Commission *paid* by American General	$ 475,000
3. Transaction date: December 1, 1974	
Required increase in reserves	$ 1,526,523
Consideration from American General	$ 1,103,310
Ceding Commission *retained* by American General	$ 423,213

4. Transaction date: October 1, 1975	
Required increase in reserves	$ 4,893,639
Consideration from American General	$ 4,893,639
Ceding Commission *paid* by American General	$ 1,600,000
5. Transaction date: December 1, 1975	
Required increase in reserves	$ 1,443,557
Consideration from American General	$ 1,028,658
Ceding Commission *retained* by American General	$ 414,899

In its tax returns for 1973-1975, petitioner included in income the full amount of required increases in reserves, and deducted the ceding commissions paid to or retained by American General.[4] Respondent, in his notice of deficiency, disallowed the deduction for the ceding commissions on the basis that such amounts were attributable to the acquisition of capital assests, for which only amortization over the anticipated useful lives of the reinsured policies was allowable.

In *Beneficial Life Insurance Company v. Commissioner,* 79 T.C. 627 (1982), we addressed the issue of whether ceding commissions paid by a reinsuring company in an indemnity reinsurance (coinsurance) transaction are currently deductible. We held that they were. We further held that the reinsuring company must include in income the full amount of the reserve liability assumed in the in-

[4] With respect to the December 1, 1974 transaction, petitioner simply included $1,103,310 in income, rather than including the full required reserve amount and then claiming a deduction for the ceding commission.

denmity reinsurance (coinsurance) transaction. The net result was that only the consideration received from the ceding company was included in the taxable income of the reinsurer. 79 T.C. at 646.

Respondent asks us to reconsider our decision in *Beneficial Life.* We decline to do so, and we adhere here to our decision in that case.[5]

To reflect concessions by the parties,

Decision will be entered under Rule 155.

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[5] We reached the same conclusion on similar facts in *Colonial American Life Insurance Company v. Commissioner,* T.C. Memo 1986-226; *Individual Life Assurance Company v. Commissioner,* T.C. Memo 1986-201; *Modern Security Life Insurance Company v. Commissioner,* T.C. Memo 1985-629.

APPENDIX D

UNITED STATES TAX COURT

Docket No. 13441-78

MERIT LIFE INSURANCE COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

DECISION

Pursuant to the opinion of the Court filed September 25, 1986, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there are deficiencies in income tax due from the petitioner as follows:

Taxable Year	Deficiency
1972	$ 29,210.17
1973	23,733.06
1975	7,910.45

That the following statement shows the petitioner's income tax liability for the taxable year 1974:

Tax assessed and paid		$1,239,724.46
Payments		
March 15, 1975	$1,021,057.44	
June 16, 1975	273,400.00	
Allowance		
Sept. 15, 1975	(54,732.65)	
Net Payments	1,239,724.46	
Tax liability		1,234,494.37
Overpayment		5,230.09

There is an overpayment in income tax for the taxable year 1974 in the amount of $5,230.09, which amount was paid on June 16, 1975, and for which amount a claim for refund could have been filed, under the provisions of I.R.C. § 6511(b)(2), on September 6, 1978, the date of the mailing of the notice of deficiency.

/s/ Julian I. Jacobs
Judge.

Entered: Apr. 14, 1987

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No. 88-955

Supreme Court, U.S.
FILED
DEC 28 1988
JOSEPH F. SPANIOL, JR.
CLERK

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1988

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
VS.
MERIT LIFE INSURANCE COMPANY.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether, in connection with the sale of indemnity reinsurance, "ceding commissions" payable by a reinsurer to the initial insurer are fully deductible in the year paid, or, instead, whether such payments must be capitalized and amortized.

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No. 88-955

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1988

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
VS.
MERIT LIFE INSURANCE COMPANY.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-23a) is reported at 853 F.2d 1435. The memorandum opinion of the Tax Court (Pet. App. 25a-30a) is unofficially reported at 52 T.C.M. (CCH) 658.

JURISDICTION

The judgment of the court of appeals (Pet. App. 24a) was entered on August 11, 1988. The petition for a writ of certiorari was filed on December 8, 1988. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATEMENT

1. Respondent is an Indiana corporation engaged primarily in the business of writing and reinsuring life insurance policies. During the years in question, it qualified for federal income

taxation as a life insurance company under Section 801 of the Internal Revenue Code.[1]

There are two general types of reinsurance: indemnity reinsurance (also known as coinsurance) and assumption reinsurance. At issue in this case is the tax treatment for ceding commissions in indemnity reinsurance transactions. Indemnity reinsurance is a method by which a life insurance company (the reinsurer or reinsuring company) indemnifies another life insurance company (the ceding or reinsured company) against all or a portion of its risk exposure under one or more insurance policies. In other words, the ceding company transfers some or all of the risks it has underwritten to the reinsurer. The ceding company reduces its reserves attributable to the transferred liabilities, and the reinsuring company increases its reserves to cover the acquired risk. Pet. App. 2a, 26a-27a.

In indemnity reinsurance, the ceding company does not relinquish any of its contractual interest in the policies it issued and remains directly liable to the policy holders. No relationship, contractual or otherwise, exists between the reinsurer and the policy holders. The ceding company pays the reinsurer a percentage of the premiums it received, upon issuance of the policies, proportional to the risk assumed by the reinsurer, which may be part or all of the total risk. The ceding company continues to pay claims and expenses and collect premiums, and pays the reinsurer a percentage of the future premiums again based on the risk transferred. In exchange, the reinsuring company reimburses (indemnifies) the ceding company for its share of the claims and expenses attributable to the risk reinsured and pays (or the ceding company retains) a ceding commission. Pet. App. 2a, 26a.

In contrast, assumption reinsurance involves the purchase of a block of insurance policies by the reinsurer from the original insurer at which point the reinsurer assumes *all* of the original insurer's risks and obligations and becomes directly liable to the policy holders. The original insurer is then relieved of all liability

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[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect in 1973-1975, the years at issue (the "Code").

under the policies and the policy holders are informed that henceforth they are insured by the reinsuring company and all future premiums are to be paid and claims made to the reinsurer. The reinsurer pays all future claims, commissions, expenses and taxes. In addition, the reinsurer assumes the entire reserve liability, thereby reducing the ceding company's reserve liability. The purchase price is normally greater than but includes a commission to the selling company. The reinsurer simply purchases the policies and steps into the shoes of the ceding or selling company. Pet. App. 3a.

During the years 1973 through 1975, respondent entered into five indemnity reinsurance agreements as reinsurer with respect to five separate blocks of life insurance policies written by American General Life Insurance Company.[2] Under these agreements, respondent agreed to reinsure specified percentages of the five blocks of policies issued by American General. Pet. App. 3a.

Three of the agreements in this case were "conventional" coinsurance agreements. Two of the agreements were "modified" coinsurance agreements, under which American General continued to maintain the reserves on the reinsured policies.[3] The ceding commissions on the foregoing agreements were either paid

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[2] Four of the blocks of reinsured policies were originally issued by American General Life Insurance Company of Delaware, and the fifth block was initially issued by American General Life Insurance Company of New York. Pet. App. 3a-4a. Both original insurers are referred to hereinafter as "American General."

[3] Modified coinsurance is a type of coinsurance which differs from conventional coinsurance in that the ceding company retains the reinsured assets, continues to carry the reserves on its books and collects any investment income derived from assets supporting the reserves. However, if the parties consent under Section 820(a) of the Code, the ceding company's retention of assets and corresponding reflection of reserves are treated for tax purposes as being merely custodial for the reinsuring company's behalf. Consequently, the same transfer of reserves from the ceding company to the reinsuring company takes places as in conventional coinsurance. Although two of the transactions herein were modified coinsurance transactions, the parties made the applicable consent under Section 820(a) of the Code; for tax purposes, then, the same

outright by respondent to American General or retained by American General. Pet. App. 4a at n.2, 27a-29a. The ceding commissions for the five transactions aggregated $1,414,467, $898,213 and $2,014,899 for the years 1973, 1974, and 1975, respectively. Pet. App. 28a-29a. Each of the agreements provided that American General could recapture the reinsured policies on specified future dates. Pet. App. 4a.

2. On its corporate income tax returns for 1973-1975, respondent deducted the full amount of the ceding commissions in the years of payment. The Commissioner disallowed the deductions claimed for the ceding commissions. The Commissioner contended that the ceding commissions should be capitalized and amortized over the estimated lives of the agreements (which ranged between 57 and 64 months). Pet. App. 4a-6a.

Respondent filed a petition in the Tax Court seeking redetermination of the alleged deficiencies, and the Tax Court ruled in its favor. Pet. App. 25a-30a. Declining to reconsider its prior decision in *Beneficial Life Ins. Co. v. Commissioner*, 79 T.C. 627 (1982), the court held that ceding commissions paid to the initial insurer in an indemnity reinsurance transaction may be deducted in full in the year of payment as "return premiums [or] *** other consideration arising out of reinsurance ceded" under Section 809(c)(1) of the Code. Pet. App. 29a-30a.

3. The court of appeals affirmed. Pet. App. 1a-23a. Noting its disagreement with the Eighth Circuit's decisions in *Modern American Life Ins. Co. v. Commissioner*, 818 F.2d 1386 (1987), and *Prairie States Life Ins. Co. v. United States*, 828 F.2d 1222 (1987), and with the Fifth Circuit's decision in *Colonial American Life Ins. Co. v. Commissioner*, 843 F.2d 201 (1988), cert. granted, No. 88-396 (Dec. 5, 1988) (Pet. App. 11a-15a), the court held that the ceding commissions in this case were currently deductible. The court of appeals thus accepted the distinction between indemnity reinsurance transactions and assumption reinsurance transactions provided by the Code and subscribed to by the Tax Court, concluding that ceding commissions paid pursuant

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results obtain as if conventional coinsurance had been used. Pet. App. 27a at n.3.

to indemnity reinsurance agreements, like agents' commissions paid pursuant to the issuance of a new insurance policy, were intended by Congress to be currently deductible. Pet. App. 13a-14a. The court concluded that the "differences [between assumption and indemnity reinsurance] substantially outweigh the similarities," and that different tax treatment of the two kinds of transactions is therefore proper. Pet. App. 15a.

REASONS FOR NOT GRANTING THE PETITION

The Petition of the government for a writ of certiorari in this case asks that plenary review of this case not be granted but asks rather that the Court hold this case in abeyance pending the outcome in *Colonial American Life Ins. Co. v. Commissioner,* cert. granted, No. 88-396 (Dec. 5, 1988), a case which presents the same question which is presented in this case. Granting the government's Petition in this case would be manifestly unfair to respondent due to the government's tactics in handling this Petition, as shown below. Consequently, respondent asks that the government's Petition be denied. If certiorari is to be granted in this case, respondent asks that this case be subject to plenary review rather than *Colonial,* or alternatively, in conjunction with *Colonial.*

DISCUSSION

The government has manipulated the timing of the appellate process of this Court in *Colonial* and in this case to prevent respondent from participating in the decision by the Court to grant certiorari for the issue involved in this case, and is now attempting by its Petition herein to prevent respondent from arguing the issue involved herein before this Court. The government's Petition herein is part of its attempt to choose *Colonial* as the case which will be argued before this Court, rather than this case, although the issue in both cases is the same. The way in which the government has so manipulated this Court's appellate process is shown by the history of the within case and of *Colonial* as set forth below.

History of Certiorari Petition in This Case. The judgment in favor of respondent in the within case was entered in the U.S. Court of Appeals for the Seventh Circuit on August 11, 1988. The government therefore had until November 9th (all dates referred to herein are in 1988 unless otherwise indicated) to petition for a writ of certiorari.

However, on October 28th, the government, on an ex parte basis, sought an extension of its time to so petition. The extension was granted on November 1st. The only reason cited by the government in its application for this extension was that the extension was needed to permit the Solicitor General to "coordinate his decision in this case with the government's response to the pending petition for certiorari" in *Colonial.* Respondent was not notified prior to the government's ex parte action of the government's intent to seek such an extension. In fact, respondent did not receive and therefore become informed of the extension application until November 2nd, the day after the extension had been granted. The government was given until December 9th to petition for a writ of certiorari in the within case.

History of Government's Response to Colonial Petition for Certiorari. Prior to its application to extend its time to petition in the within case, the government had twice obtained extensions of time to respond to the petition of Colonial American Life Insurance Company to this Court for certiorari, which petition was filed August 22nd. The reason the government sought the delay in *Colonial* was based on its need to determine whether a conflict existed between the Fifth Circuit Court of Appeals decision in *Colonial* (843 F.2d 201) and the decision of the Seventh Circuit Court of Appeals in the within case. The government's response was finally due in *Colonial* on November 15th. It was on that date that the government filed its papers agreeing with the *Colonial* petition for certiorari on the basis of the conflict with the Seventh Circuit's decision in this case.

Effect of Colonial Certiorari on This Case. As shown from the foregoing examination of the government's actions in *Colonial,* and in the within case, the government knew on November 15th, when it agreed to the certiorari petition in *Colonial,* that it would seek certiorari in the within case. It also knew that only the

respondent herein had reasons for raising any arguments against the Court's choosing to review the issue presented by these cases at this time. Nevertheless the government took full advantage of the ex parte extention this Court granted the government and delayed filing for certiorari in the within case.

On December 5th, the Court granted the *Colonial* petition for certiorari. The government in its Petition herein, filed three days later on December 8th, has now asked the Court to hold respondent's case in abeyance and hear only *Colonial*. Because certiorari has been granted in *Colonial*, the respondent has been prevented, by the government's delay in this case, from raising the valid arguments which exist against granting certiorari in either of these cases. It is respondent's position that plenary review is proper in neither *Colonial* nor this case because of the extremely narrow issue involved which affects only life insurance companies which sell reinsurance. Further, this issue is presently before the U.S. Court of Appeals for the Ninth Circuit. *Oxford Life Ins. Co. v. United States*, No. 88-2295 (9th Cir.). This Court should not review a case presenting a narrow issue such as this which has not yet been fully subject to appellate court analysis.

Effect of Timing of Petition Herein. By means of its Petition filed herein, given the fact that it was filed after the *Colonial* certiorari decision had been made by both the government and the Court, the government is seeking to select the opponent it prefers to face in presenting the issue involved herein to the Court. The Court and the respondent herein should have a role in the process of determining which case goes before the Court. If the government's Petition herein is granted, respondent will be prevented from presenting its case to the Court, a case which respondent has successfully presented in the lower courts. The government will be allowed to select the *Colonial* case to present to the Court, which it has successfully presented in a lower court. The Court should not allow the government to select its opponent, or to benefit so greatly from the ex parte extension granted in good faith by the Court in this case based upon the government's stated need for such extension, *i.e.*, to coordinate this case with *Colonial*, when such need clearly ceased to exist on November 15th.

The government could have and should have filed a petition for plenary review in this case on November 15th in conjunction with its agreement to certiorari in *Colonial*. Respondent would then have had a forum to present its arguments against certiorari in these cases, and, if unsuccessful in such arguments, to present its arguments on the merits of this case to the Court. The government's delay in filing the Petition herein beyond November 15th was unjustified. Only the government's continued unjustified delay beyond December 5th, the date of the Court's certiorari decision in *Colonial*, has allowed the government to request the disposition of this case which is set forth in its Petition, which would prevent respondent from arguing either the certiorari question or the substantive question involved herein before the Court. Consequently, this Petition should be denied. In light of the fact that certiorari has been granted in *Colonial*, respondent recognizes that it is unlikely that such denial will be granted. Therefore, in the event such denial is not granted, respondent asks this Court to grant plenary review in this case rather than in *Colonial* so that respondent, for the reasons set forth above, may have an opportunity to present its case to this Court. It should be noted that although certiorari has been granted in *Colonial*, no briefs have been filed in that case. It is believed that the petitioner's brief in *Colonial* is not due until after January 15, 1989. Alternatively, respondent asks that plenary review be granted in both cases.

CONCLUSION

The petition for a writ of certiorari should be denied. If it is not denied, plenary review of this case rather than *Colonial* should be granted. Alternatively, plenary review should be granted in both cases.

Respectfully submitted,

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